United States Court of Appeals
for the Second Circuit

APPELLEE'S BRIEF

75-4227

Signed

IN THE UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT

ESTATE OF EDWIN C. WEISKOPF, Deceased,
ANNE K. WEISKOPF and SOLOMON LITT, Executors
and ANNE K. WEISKOPF, Surviving wife,

Appellants

v.

COMMISSIONER OF INTERNAL REVENUE,

Appellee

EDWIN C. WHITEHEAD and JOSEPHINE WHITEHEAD,

Appellants

v.

COMMISSIONER OF INTERNAL REVENUE,

Appellee

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ON APPEAL FROM THE DECISIONS OF THE
UNITED STATES TAX COURT

BRIEF FOR THE APPELLEE

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STATEMENT OF THE ISSUES PRESENTED

1. Whether the Tax Court correctly determined that Ininco, Ltd., was a controlled foreign corporation within the meaning of Section 957 of the Internal Revenue Code of 1954, so that the gain received by taxpayers was subject to treatment as dividend income to the extent provided by Section 1248 of the Code.

2. Whether transfer of Intapco stock to Hong Kong Holdings and the subsequent distribution constituted a liquidation of Ininco rather than a sale.

3. Whether one half of Ininco's earnings and profits was attributable to Weiskopf.

STATEMENT OF THE CASE

The estate of Edwin C. Weiskopf, its executors and Weiskopf's surviving wife and Edwin C. Whitehead and Josephine Whitehead[1/] appeal from decisions of the United States Tax Court. The Tax Court determined that Weiskopf's estate owed a deficiency of $411,372.69 in income taxes for the year 1966 and that Whitehead owed a deficiency of $397,396.56 in income taxes for the same year. The findings of fact and opinion of the Tax Court filed on April 17, 1975 (Honorable Darrell D. Wiles), are reported at 64 T.C. 78. Taxpayers each filed their timely notice of appeal on October 6, 1975. Jurisdiction is conferred on this Court by Section 7482 of the Internal Revenue Code of 1954.

The pertinent facts may be summarized as follows:

Weiskopf and his son Whitehead during the years 1963 through 1966 served respectively as chairman of the board of directors and as president of their wholly owned corporation, Technicon

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1/ Edwin C. Weiskopf and his son Edwin C. Whitehead will hereinafter sometimes be referred to as taxpayers.

Instruments Corporation (Technicon). This corporation primarily manufactured and sold scientific instruments. In 1957, Technicon had acquired the patent rights to the Autoanalyzer which was to become its most important product. (R. 234-235.)

Prior to 1963, Technicon produced Autoanalyzers that were sold world wide with the exception of the United Kingdom and some Commonwealth countries. In the late 1950's, Technicon Instruments Company, Limited (Limited) had been organized as a wholly owned subsidiary of Technicon. At first Limited assembled and sold, in the United Kingdom, Autoanalyzers from parts made in the United States. Eventually it started its own manufacturing operations, and as 1963 approached, Limited's manufacturing capability was such that it could supply Autoanalyzers to the world market outside the United States. (R. 235.)

From 1963 through 1966, Limited's directors were Edwin C. Weiskopf, his son Edwin C. Whitehead, William Robert Carr and Leslie James Evans. In addition to being a director of Limited, Evans was its operating head. (R. 235.)

Carr, as well as being a director of Limited, was a solicitor with the firm E. F. Turner & Sons in London, England. Carr and his firm represented both Technicon and Limited from the time of their incorporation, with respect to their activities in the United Kingdom. (R. 236.)

2/ "R." references are to the separately bound record appendix.

Carr approached the directors of Limited with the idea that an Overseas Trade Corporation (OTC) be created under the laws of the United Kingdom. An OTC would permit an exemption from United Kingdom tax on income and profits earned outside the United Kingdom. Limited's directors advised Carr to investigate the concept and work out the means to implement it. (R. 236-237.)

After the plans for establishing an OTC were formulated, Carr became concerned that a company wholly owned by Whitehead and Weiskopf might become subject to a "surtax direction." The surtax direction, which, Carr testified, was similar to an accumulated earnings tax would have, in Carr's opinion, partially negated the tax benefits of an OTC. Carr then suggested to Whitehead and Weiskopf that they have 11 shareholders in the OTC or alternatively that 51 percent of the voting power in the OTC be given to a publicly owned company in England. Taxpayers vigorously rejected both of these suggestions, but they eventually accepted an arrangement whereby 50 percent of the nominal voting power would be given to a British public company. (R. 237.)

Carr then approached several people as possible investors in the OTC. Among them were Bernard Franklin of the Romney Finance Company, Limited (Romney). (R. 235-237.) Romney was a corporation wholly owned by Unex Investment Trust Limited (Unex), a British "investment holding company" which was engaged

in the business of investing in the shares of publicly traded securities. Unex had formed Romney to undertake "dealing operations" which Unex was precluded by law from undertaking itself. Among such "dealing operations" was the making of investments in private companies. (R. 235-236.) Carr also acted as Unex's and Romney's solicitor. (R. 118.)

Bernard Franklin, a chartered account and senior partner in an accounting firm, served on Unex's board of directors from 1963 through 1968 and also served on Romney's board of directors from the time of its incorporation in 1962. He had never been an officer, director, or employee of Technicon, Limited or any of their subsidiaries. (R. 236.)

Carr initially offered Romney, through Franklin, a dividend rate of 8 or 9 percent for an investment in the proposed OTC. Eventually a rate of 12 1/2 percent was agreed upon. This rate was approximately 5 percent higher than the prevailing bank interest rates and was substantially higher than the rate of return on government stocks. (R. 237-238.)

Intapco, Inc. was incorporated in New York on November 22, 1963, for the purpose of holding stock in Ininco, the proposed OTC.[3/] Intapco, which earned no income, had two classes of stock

3/ During this period taxpayers and Technicon, were also represented by United States counsel--Mr. Mark Johnson who advised them as to tax matters and Mr. Alvin Lurie who advised them as to corporate matters. Lurie and Johnson discussed the organization of the proposed OTC with taxpayers. (R. 84.) Lurie, at present, is an Assistant Commissioner of Internal Revenue and Johnson, is co-author of the treatise, Rabkin and Johnson, <u>Federal Income, Gift and Estate Taxation</u>.

(1) 100 shares of common and (2) 500 shares of preferred stock. Par value of each type of stock was $100 per share. Whitehead, upon incorporation of Intapco subscribed to 70 shares of common stock and Weiskopf subscribed to 490 shares of preferred; each paying par per share. (R. 238.)

Weiskopf on November 24, 1963, entered into an agreement with Intapco which permitted him during his lifetime to convert up to 70 shares of his preferred shares into common stock share for share if <u>inter alia</u> (1) Intapco terminated in any manner its entire stock interest in any company which handled any Technicon products regardless of whether such companies were connected through stock ownership, and (2) if the holders of not less than 50 percent of Intapco common stock agreed to the sale or other disposition of such stock. (R. 238-239.)

Ininco, incorporated on November 28, 1963, under the laws of the United Kingdom, qualified as an OTC and consequently was exempt from United Kingdom income and profit tax on trading income from outside the United Kingdom. (R. 240.)

Ininco had three classes of stock. The first class consisted of 250 preferred ordinary shares and was owned entirely by Romney which had paid 25,000 pounds for the shares.[4/] Romney as owner of the preferred ordinary shares was entitled to one vote per share and as the owner of this class was entitled to appoint not more than two of Ininco's four directors. Intapco owned the remaining Ininco shares--250 deferred ordinary shares and 175 second preferred ordinary shares for which it paid 2,500

4/ During all relevant years the exchange rate was $2.786 to one pound.

pounds and 17,500 pounds respectively. Like the preferred ordinary shareholders, the deferred ordinary shareholder, Intapco, was entitled to one vote per share and could also appoint two directors.[5/] During Ininco's existence the four directors were Weiskopf and Whitehead (elected by Intapco) and Bernard Franklin and Maurice Goldwater (elected by Romney). (R. 241.)

Ininco's articles of association also provided (1) that the preferred ordinary shares owned by Romney were to receive an annual dividend of 12 1/2 percent (2) that the second preferred ordinary shares were entitled to an annual cummulative dividend of 4 percent and (3) that the balance of the profits was payable to the second preferred ordinary shares and the deferred ordinary shares. Upon termination, the preferred ordinary shareholders and the second preferred ordinary shareholders were entitled to a preference respectively of the return of their investment and accumulated dividends. The balance was to be distributed to the holders of the second preferred ordinary shares and deferred ordinary shares in proportion to their investment. (R. 241-242.)

Ininco's articles of association also provided that a shareholder who desired to sell his shares was required to offer the shares to the other shareholders first. Even if the other shareholders did not desire to purchase these shares,

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5/ The shareholders of the second preferred ordinary shares had no voting rights. (R. 240.)

Ininco's board could decline to register the transfer of the shares to another party. (R. 242.)

On November 29, 1963, Ininco's shareholders entered into an agreement which provided, in effect, that if a shareholder desired to dispose of its shares, it must first offer them to the remaining shareholders. A failure by the other shareholder to purchase the shares would allow the offering shareholder to sell the shares to others or call for Ininco's liquidation. In the event of a sale to the other shareholders the selling shareholders would receive the amount to which they would be entitled upon Ininco's liquidation. (R. 242-243.)

The agreement further provided (1) that the shareholders would endeavor to prevent a deadlock in their capacity as shareholders and directors and (2) that arbitration was to be used to settle any question arising as to the interpretation of the agreement or the rights, duties and liabilities of the parties.6/ (R. 244.)

Finally the shareholders agreement provided (1) that after Ininco's dissolution, or the sale of its shares, neither Intapco nor Romney had, solely by virtue of their interest in Ininco, any right to the name, customers, good will or the continued handling of the Autoanalyzer, (2) that Weiskopf and Whitehead were free to engage in any business activity that might be competitive with Ininco and (3) that neither Intapco nor

6/ The arbitration was to be guided apparently by the law of Great Britain. (Ex. 14-N, par. 13.)

Romney had any right to any commercial opportunity or benefits which could be deemed to belong to Ininco, its shareholders or its beneficial owners. (R. 244; Ex. 14-N, par. 10.)

Limited in the meantime continued to sell Autoanyalyzers in the United Kingdom market, and began to sell to Ininco Autoanyalzers for resale in the world market outside of the United States and the United Kingdom. Ininco would sell the Autoanalyzers to its overseas agents and distributors some of which were affiliated with Technicon. Eventually Ininco established its own offices in foreign countries. (R. 244, 245.)

Evans, the managing director of Limited served as Secretary of Ininco and in actuality was also its managing director. Carr, taxpayers' solicitor, was required to countersign all checks in excess of 500 pounds. (R. 245.)

Ininco had been established, in part, to take advantage of United Kingdom tax benefits and build up capital to finance what was to be Technicon's rapidly expanding export business. This was to be accomplished by using tax deferred funds to finance overseas offices affiliated with Technicon. (R. 245.)

The special tax treatment given to OTC was ended by legislation enacted in 1965, and effective as of April 6, 1966. Carr advised taxpayers that the repeal of the OTC legislation would result in Ininco's no longer being exempt from United Kingdom income and profit taxes. Accordingly taxpayers, realizing that Ininco would no longer serve any useful purpose, decided to terminate Ininco's existence. Carr determined that liquidation of

Ininco would result in a 40 percent British tax on the liquidation distributions but that a non-British resident could receive Ininco's dividends in gross. Accordingly, Carr worked out an arrangement whereby taxpayers' Intapco stock and Romney's Ininco stock would be sold to a Hong Kong corporation--Hong Kong Holdings Limited which was a subsidiary of a major Hong Kong corporation. (R. 246-247.)

On December 6, 1965, taxpayers entered into an agreement whereby Weiskopf exercised his option and converted 50 shares of Intapco preferred stock into 50 shares of its common stock and Whitehead reduced his common stock also to 50 shares. (R. 247-248.)

Carr approached Romney through Franklin in December of 1965 to inquire whether Romney was ready to dispose of or sell its interests in Ininco because Intapco and Technicon were no longer going to use Ininco. Although Franklin testified that at first he had objected to the sale of Ininco because the investment had been viewed as long term, he soon acquiesed in the sale, suggesting that Romney receive some premium for its being willing to go along with the sale to Hong Kong Holdings. (R. 248.)

On February 21, 1966, taxpayers and Hong Kong entered into an agreement for taxpayers to sell their Intapco stock to Hong Kong for the greater of 735,000 pounds or the excess of Ininco's assets over its liabilities less 15,000 pounds. The agreement also required taxpayers to arrange for Romney to sell its shares to Hong Kong at par value. If Hong Kong could not persuade the British tax authorities to treat the liquidation of Ininco in a tax free manner, it had the option to

rescind the sales contract. In its application to Inland Revenue, Hong Kong Holdings attested that it was the beneficial owner of and beneficially entitled to the dividends arising from the outstanding shares of Ininco. On February 28, 1966, Inland Revenue granted Hong Kong Holdings authority to pay dividends out of net exempt trading income without a deduction of United Kingdon tax. (R. 248-249.)

The minutes of Ininco's March 14, 1966, board meeting reflected a resolution that a dividend in the amount of the available exempt trading income (500,000 pounds) be declared for those beneficially entitled holders of the deferred ordinary shares. The board minutes of March 21, 1966, contained a resolution to declare an additional dividend of 305,000 pounds in favor of the holders of the deferred ordinary shares. On March 23, 1966, a resolution calling for the winding up of Ininco was unanimously passed. By this time four new directors had replaced Franklin and Goldwater and Weiskopf and Whitehead who had resigned by March 14, 1966. (R. 250-252.)

Weiskopf and Whitehead received the following amounts from Hong Kong Holdings pursuant to the agreement of February 21, 1966 (R. 252.)

March 1, 1966	$ 100,000.00
March 15, 1966	500,000.00
March 16, 1966	681,278.02
March 22, 1966	450,000.00
March 23, 1966	249,620.13
May 4, 1966	124,976.18
	2,255,874.33

Hong Kong Holdings paid Whitehead $1,100,654.16 and Weiskopf $1,155,220.17 for their Intapco stock. Each taxpayer reported the gain on the sale of their Intapco stock as long-term capital gain. (R. 252.)

After Whitehead and Weiskopf were advised that Ininco would no longer gain the benefits of tax deferral offered by the OTC provisions they sought to establish a manufacturing and selling operation outside of England.

In August of 1965, the Government of Ireland gave a grant to Technicon (Ireland), which pursuant to Irish law abated until December 21, 1981, the Irish tax laws applicable to the new corporation. Technicon (Ireland) then took over the markets previously served by Ininco. Limited (England) continued to manufacture and sell Autoanalyzers on a much smaller scale than when it had sold to Ininco. (R. 251-252.)

In his statutory notice of deficiency, the Commissioner determined that the sale of the Intapco stock represented the sale of an interest in a controlled foreign corporation resulting in ordinary income treatment of the gain on the sale of stock. In amendments to his answer in the Tax Court, the Commissioner further alleged that the sale of Intapco stock was a sale in form only and that the transaction was in substance a liquidation. (R. 255.) The Tax Court upheld, with a presently uncontested adjustment, the Commissioner's position.

From the decisions the taxpayers appeal.

SUMMARY OF ARGUMENT

Taxpayers, through Intapco--a wholly owned United States corporation--held 50 percent of the nominal voting rights in Ininco--a United Kingdom corporation that was exempt from British income and profit taxes on sales made outside the United Kingdom. When it appeared that Ininco would no longer be exempt from such taxation, taxpayers' solicitor arranged to have the Intapco stock "sold" to a Hong Kong Company which would liquidate Ininco, allowing the earnings and profits of Ininco to be withdrawn without the imposition of a British tax on the liquidation distributions. This appeal presents the questions (1) whether Ininco was a controlled foreign corporation within the meaning of Section 957 of the Code so that the gain received by taxpayers was subject to treatment as dividend income (2) whether the transfer of Intapco stock to Hong Kong Holdings and the subsequent distribution constituted a liquidation of Ininco rather than a sale, which affects the amount to be treated as dividend income, and (3) whether one half of Ininco's earnings and profits was attributable to Weiskopf who, on the day prior to the sale, exercised a pre-existing option to convert his preferred stock to 50 percent of the common.

1. This Court has recognized that in defining a "controlled foreign corporation" as any foreign corporation in which United States shareholders own more than 50 percent of the total

combined voting power of stock, Congress was concerned with real rather than nominal voting power. Thus, the Treasury Regulations provide several tests for determining whether United States shareholders own more than 50 percent of the total combined voting power of a corporation even though they nominally own only 50 percent or less of the voting rights.

Here, as the Tax Court found, Ininco was a controlled foreign corporation even though taxpayers nominally held only 50 percent of the voting rights. First, Romney, the only other shareholder in Ininco had a limited stake in Ininco's success and was given voting rights which were substantially greater than its proportionate share of the corporate earnings which was limited to a 12 1/2 percent yearly dividend. Indeed a strong indication that Romney's stake in Ininco was quite limited is the fact that Romney could only force a liquidation of Ininco or offer its interest to Intapco, receiving in either event only a return of its investment plus accrued dividends. Second, the taxpayers retained dominion and control over Ininco. This is reflected in that Romney gave up what voice it had in Ininco to Evans the managing director of another of taxpayers' British subsidiaries. Moreover, the events leading up to the liquidation of Ininco show that the transaction was totally engineered by taxpayers and their solicitor who only informed Romney after the transaction had been set in motion.

Finally, Romney would have had little interest in disturbing taxpayers' control of Ininco since Ininco's existence and profit making ability depended entirely upon the cooperation of the taxpayers. Thus, the sum total of all the factors presented supports the Tax Court's factual finding that Ininco was a controlled foreign corporation.

2. If, as the Tax Court correctly concluded, the transfer of Intapco shares to Hong Kong Holdings was a liquidation of Ininco the proceeds received by taxpayers in the transaction will be treated as ordinary income. On the other hand, if taxpayers prevail in their contention that the transaction was in substance a sale, a portion of the proceeds which taxpayer received would be taxed at capital gains rates. It has long been held that the tax consequences of a transaction are determined not by the form in which the transaction is cast but by the reality of what has actually occurred and accordingly the question of whether a corporation has been liquidated is one of fact to be determined by whether a corporation has manifested an intent to wind up its affairs. Here the transaction was not a sale for tax purposes because all that taxpayers did was cause cash from one pocket to be transferred to another pocket using a different pair of trousers in order to permit taxpayers to minimize taxes paid to the United Kingdom. Any argument that there was no agreement on Hong Kong Holdings part to liquidate

Ininco is merely an attempt to have this Court ignore what all the parties to the transaction clearly understood. The transaction in question was a mere shifting of cash, for a fee, to avoid certain tax consequences. Section 1248 was enacted to provide the imposition of full United States tax when income earned abroad is repatriated. This aim can only be supported here by affirming the finding of the Tax Court that the purported sale was in substance a liquidation.

3. Weiskopf argues that even if Ininco was a controlled foreign corporation and the purported sale to Hong Kong Holdings was in actuality a liquidation, one half of Ininco's earnings and profits should not be attributable to him because he only held Intapco common stock for one day. Weiskopf, however, by having the option to convert the preferred shares into 50 percent of the commom, must be considered to have held 50 percent of the Intapco stock from the inception of the corporation. Moreover, the Treasury Regulations, for purposes of Section 1248, provide that a shareholder is considered to have held his stock acquired in a tax free transaction during the entire period he held the property given up in exchange. Thus, Weiskopf is considered to have held his share of the Intapco common stock from the time he purchased the preferred Intapco stock.

The decisions of the Tax Court should be affirmed.

ARGUMENT

I

THE TAX COURT CORRECTLY DETERMINED THAT ININCO, LTD. WAS A CONTROLLED FOREIGN CORPORATION WITHIN THE MEANING OF SECTION 957 OF THE INTERNAL REVENUE CODE OF 1954, SO THAT THE GAIN RECEIVED BY TAXPAYERS WAS SUBJECT TO TREATMENT AS DIVIDEND INCOME TO THE EXTENT PROVIDED BY SECTION 1248 OF THE CODE

A. The statutes are intended to prevent the avoidance of taxes by use of controlled foreign corporations which accumulate income abroad for the benefit of United States taxpayers

Prior to 1962, most foreign corporations, even though American-controlled, were exempt from United States tax on their foreign-source income, and their United States shareholders were taxed on their share of the earnings of such corporations only when received by them through distribution or as the proceeds of a sale or redemption of their stock. As a result, United States taxpayers could invest in a foreign corporation and be subjected to a relatively low amount of foreign tax on its current earnings. After the earnings were accumulated for a time, they could be repatriated by means of a liquidation or sale at preferential capital gains tax rates. The tax savings were often considerable.

To remedy some of these abuses, and to reduce the amount of capital that was flowing abroad because of more lenient foreign tax laws, President Kennedy recommended in his 1961 Tax Message to Congress that such tax havens be eliminated. See President's Tax Message, April 20, 1961, H. Doc. No. 140, 87th Cong., 1st Sess., p. 7. Congress responded to the

President's recommendations by enacting in the Revenue Act of 1962 (P.L. 87-834, 76 Stat. 960, Sec. 12), Subpart F of the Code--a complex panoply of provisions applicable to United States shareholders of a "controlled foreign corporation" and Section 1248 of the Internal Revenue Code of 1954, Appendix, infra, a companion provision designed to govern sales or exchanges of stock in a foreign corporation.

This appeal presents a question involving both subpart F and Section 1248. In its broadest sense, the issue is whether the gain realized by taxpayers upon the sale of Intapco, Inc.,--a corporation wholly owned by taxpayers and a shareholder of a British overseas trading corporation not subject to British income and profits taxes--must be treated as dividend income to the extent provided by Section 1248, as the Tax Court held, or a long-term capital gain, as taxpayers contend.

Before Section 1248 becomes operative several conditions must be met. First, the taxpayer must be a "United States person" who has sold or exchanged stock in a foreign corporation.[7/]

7/ Section 1248(e) provides that if a domestic corporation was formed or availed of principally for the holding of stock of a foreign corporation the sale of the stock of the domestic corporation should be treated as the sale of the stock of the foreign corporation. It is undisputed here that Intapco was formed for the sole purpose of owning stock in Ininco. Intapco, in turn, was wholly owned by taxpayers.

Insofar as is pertinent here, "United States person" means a citizen or resident of the United States. Secs. 957(d) and 7701(a)(30), Internal Revenue Code of 1954, Appendix, _infra_. Second, the taxpayer must have been a "United States shareholder" within the meaning of Section 951(b), Appendix, _infra_--i.e. a United States person owning 10 percent or more of the total combined voting power of all classes of stock of the corporation entitled to vote at any time during the five-year period preceding the transaction. Third, the taxpayer's 10 percent ownership must have coincided with the corporation's status as a "controlled foreign corporation" within the meaning of Section 957(b), Appendix, _infra_--i.e., a foreign corporation of which more than 50 percent of the total combined voting power of all classes of stock entitled to vote is owned by "United States shareholders." If Section 1248 applies, then any gain recognized by the taxpayer upon the sale must be treated as a dividend to the extent of the corporation's earnings and profits (attributable to the stock sold) that were accumulated after 1962, and during the period that the taxpayer held the stock and the corporation was a "controlled foreign corporation."

Since it is undisputed that taxpayers here are United States persons, as defined in Section 957(d), who owned 10 percent or more of the total combined voting power of Ininco, the application of Section 1248 here turns on whether Ininco

was a controlled foreign corporation as defined in Section 957(a), Appendix, _infra_. Resolution of that question, in turn, depends on whether taxpayers are deemed to have owned more than 50 percent of the total combined voting power of all classes of Ininco stock.

B. Taxpayers owned more than 50 percent of the total combined voting power of all classes of Ininco stock

Section 957(a) of the Internal Revenue Code of 1954, provides that a "controlled foreign corporation" is any foreign corporation in which United States shareholders own more than 50 percent of the total combined voting power of stock entitled to vote on any day of the corporation's taxable year. In enacting this provision Congress was not concerned merely with nominal voting power but rather real voting power. _Kraus_ v. _Commissioner_, 490 F. 2d 898, 901 (C.A. 2, 1974); _Garlock Inc_. v. _Commissioner_, 489 F. 2d 197, 201-202 (C.A. 2, 1973). Accordingly, the Treasury Regulations (§ 1.957-1(b), Treasury Regulations on Income Tax (1954 Code), Appendix, _infra_) provide that in determining whether United States shareholders own more than 50 percent of the total combined voting power of a corporation, consideration will be given to the facts and circumstances of each case. Thus, the Regulations provide that United States shareholders will be deemed to own the requisite percentage if, there exists an agreement or arrangement by which they control the corporation's

operations and policies even if they have the power directly to vote only one half or less of the total stock. Secondly, the Regulations provide that the voting power ostensibly provided any class of stock will be deemed owned by any person on whose behalf it is exercised. Thirdly, it provides that voting power ostensibly provided to owners of a second class of stock in a foreign corporation will be disregarded if its percentage of voting power is substantially greater than the stock's proportionate share of corporate earnings and if the facts indicate (1) that the shareholders do not exercise their voting rights independently and (2) that a principal purpose of the arrangement is to avoid having the corporation classified as a "controlled foreign corporation." This interpretation by the Regulations that real, as contrasted to illusory voting powers is determinative, is in accord with the fundamental principles that taxation depends on substance rather than form, unless Congress has provided otherwise. Gregory v. Helvering, 293 U.S. 465, 469 (1935); Kraus, supra, Garlock Inc., supra.

This Court, in Garlock and in Kraus, has recognized that the Regulations under Section 957, Appendix, infra, are proper and within the direct aim and purpose of the statute. In Garlock, the taxpayer, an industrial manufacturing corporation, in order to avoid having a wholly owned foreign subsidiary characterized as a controlled foreign corporation,recapitalized the subsidiary by creating

a class of cummulative, preferred stock. Like the preferred stock here, this new issue of stock had a dividend rate exceeding the interest rate prevailing in the foreign market and was subscribed to by a subsidiary of a corporation which had as counsel the same law firm as Garlock. The preferred shares were to be transferred only with Garlock's consent.[8/] Any dispute between shareholders was to be submitted to arbitration and it was also agreed that the subsidiary was to retain a net current asset value of at least 200 percent of the total value of the preferred stock. Each preferred stockholder after one year had the right, with 120 days notice, to sell the preferred stock at par. In holding that Garlock's subsidiary was a controlled foreign corporation within the meaning of Section 957 of the Code, this Court examined the regulation, concluded that a principal purpose of the transaction was to avoid classification of the subsidiary as a controlled foreign corporation and stated (489 F. 2d, p. 200):

> While it is suggested that the holders of the preferred could have exercised voting rights independently, in fact, there is no indication that they did so * * * Finally, the percentage of mathematical voting power of the preferred shareholders (50 per cent) was substantially greater than its

8/ Here, the preferred ordinary shares, before they could be transferred, had to be first offered to Intapco. (R. 242-243.)

> proportionate share of the corporate earnings: in 1963, 1964 and 1965 S.A.'s net profit was $94,260.61, $173,382.60 and $50,171.20 respectively, but the preferred shareholders received dividends of only $8,000 per year--in other words, in the year 1965 a maximum of 16 per cent. (Emphasis in original.)

This Court also stated (489 F. 2d, p. 201-202):

> It is significant here that the taxpayer sought out parties who understood both its motives and its situation. It is significant also that the terms of the arrangement worked out were such that the preferred shareholders would have no interest in disturbing the taxpayer's continued control. The stock was made attractive by paying a rate in excess of market for the money advanced. The stake of the preferred shareholders was, moreover, quite limited, since the moment the current asset value of S.A., or its working capital was not maintained at a level of at least 200 per cent of the total par value of the preferred, i.e., $200,000, any preferred shareholder could demand a purchase by * * * [the corporation] at par; indeed, after one year the preferred shareholders had the right on 120 days' written notice to require * * * [the corporation] to purchase the preferred at par, that is, to have his original investment returned in full.

Thus, this Court concluded (489 F. 2d, p. 202):

> While in a given case the issuance of a different class of stock with equal voting rights might meet the "voting power" requirement in the statute, quite obviously Congress could not generally have conceived all the ramifications of corporate laws around the world which might cleverly be utilized to make a preferred stock which was rather readily redeemable and carried only a very small percentage of the earnings as interest the equivalent in voting power of common stock held by the United States shareholders.

Similarly in Kraus, taxpayers owned all of the stock of a Liechtenstein corporation engaged in the business of reprinting and selling foreign out-of-print materials. In 1962, the corporation was recapitalized so that the taxpayers continued to own all the common shares and retained 50 percent of the voting rights--the remaining 50 percent of the voting rights was given to the shareholders of the newly created preferred stock. As in Garlock and here, the preferred shares could only be transferred with the approval of the board of directors. Once again this Court in Kraus (p. 901) rejected a mechanical test of voting rights and looked to "the actualities stressed in Garlock and in the Treasury Regulations." This Court stated in Kraus (p. 902) that it "defied credulity" to believe that the taxpayers would have given up 50 percent control of a corporation to shareholders who were making a capital contribution of 10 percent of the corporation's net worth. Moreover, this Court considered that the new preferred stockholders were selected so that they would not upset the situation and that the corporation's board of directors had the right to redeem the preferred shares at par value plus accrued dividends on three months notice. Like here, there was no arrangement for the breaking of a deadlock and "in view of the call provisions, the redemption of any dissident stockholder's shares at par value provided an obvious solution

to any problem." (490 F. 2d, p. 902.) Subsequently the preferred stockholders, like Romney did here, sold their shares to a third party which also acquired the taxpayer's shares.

In reaching its holding that the corporation was a controlled foreign corporation this Court stated (490 F. 2d, p. 903):

> While it is true that the preferred stockholders were represented at all of the meetings held during the relevant period * * * The record is barren of any indication of dissent or disapproval of any preferred stockholder in person or by proxy at any meeting. It is urged that KRL was a successful, well-managed corporation, and that preferred stockholders with an assured 8% return on their investment could hardly be expected to be unruly. Whatever force this argument possesses evanesces when we examine the orchestrated demise of the preferred stockholders, which was marked with the same complacency and obeisance which characterized their brief tenure as shareholders in KRL.

Thus, in considering these factors this Court concluded that an examination of the facts (490 F. 2d, p. 903)--

> lead to the conclusion that taxpayers never surrendered any real voting power to the preferred stockholders. While no single factor set forth here might in itself be sufficient to establish that KRL was a "controlled foreign corporation" within the meaning of Section 957(a) of the Internal Revenue Code, the sum total establishes beyond any doubt that the conclusion of the Tax Court was sound.

Here too, an examination of the circumstances compels the conclusion that the Tax Court correctly determined that Ininco was a controlled foreign corporation. While Romney nominally had 50 percent of the voting rights in Ininco, it is clear (1) that Romney's voting rights were substantially greater than its proportionate share of the corporation's earnings (2) that Romney failed to exercise independently its voting rights and (3) that a purpose of structuring the corporation in such manner was to avoid its classification as a "controlled foreign corporation."

As the Tax Court recognized, Romney as a preferred shareholder, had a limited stake in Ininco's success, so that its nominal voting power was substantially greater than Romney's proportionate share of the corporate earnings. Indeed, Romney's position was closer to that of a creditor rather than an investor in equity. Romney invested 25,000 pounds in Ininco and received 50 percent of the nominal voting rights in the corporation. Taxpayers' investment of 20,000 pounds gave them the other 50 percent of the nominal voting rights. Yet Romney's return was limited to a 12 1/2 percent yearly dividend. Indeed upon Ininco's liquidation Romney was only entitled to receive a return of its 25,000 pound investment plus any accrued dividends. The striking disproportionality between Romney's voting right and its share of Ininco's earnings is strikingly demonstrated

by the difference between Romney's return and taxpayer's increase in their investment in Ininco. (Exs. 20-T, 26-Z, 31-EE-36-JJ):

Period Ending	Ininco's Profits	Romney's Dividends	Increase in Taxpayer's interest
Nov. 30, 1964	294,305 pounds	1,914 pounds	337,392 pounds
Nov. 30, 1965	335,064 pounds	1,835 pounds	670,620 pounds
March 23, 1966	181,693 pounds	1,052 pounds	807,313 pounds

Accordingly, it can hardly be said that Romney's nominal voting power was proportionate to its share of the corporation's earnings. Moreover, the testimony of Franklin, Romney's managing director, also bears out the fact that Romney regarded the dividends as the payment of interest on debt rather than a return on equity (R. 139):

> Q So that, actually, insofar as Romney was concerned, you were getting a very good rate of return.
>
> A Yes. I can't speak for this for certainty but I have it in mind that at the time the bank rate * * * in the United Kingdom, was 5 per cent and the normal lending rate for a good risk would have been 2 per cent over bank rates so that would have been 7 per cent. So you have to compare that with the 12 and a half percent.

Franklin also testified regarding the establishment of Technicon, Ireland (R. 138):

> Q Did you inquire as to what would happen to the business of Ininco?
>
> A I really can't answer that question at this distance in time. I don't think I would have been concerned. The only relevant point, it would seem to me, would be that Romney would sell its holding in Ininco. You must bear in mind that this is a fixed interest a fixed dividend holding and Romney had no interest in the equity of the company.

The fact that Romney could only force a liquidation or offer its stock interest to Intapco and receive a return of its investment (R. 261) is also strong indication that Romney's stake in Ininco was quite limited even though it nominally had 50 percent of the voting power. See Garlock, Inc. v. Commissioner, 489 F. 2d 197, 201, 202 (C.A.2, 1973). Thus, since Romney could expect to receive only a return of its investment, taxpayers are hard pressed to assert that Romney's nominal voting rights and its stake in Ininco were in some sort of equilibrium.

Also, as the Tax Court found, taxpayers retained dominion and control over Ininco. Indeed, while Romney nominally had 50 percent of the voting power, this power was never exercised. During the two years and three months that Romney was a shareholder of Ininco, no shareholders' meeting was held. Nor did Romney, although given the power to do so, request that such meeting be held. Romney admittedly did appoint two members of Ininco's board of directors but they in effect gave up their power to Evans, the managing director (President) of Ininco and Limited. (Op. 37.)[9] The directors appointed by Romney were Mr. Franklin

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9/ Although taxpayer Whitehead asserts (Br. 20) that the operations were in large measure conducted from Ininco's office in Holland, it is clear that policy decisions were made by Evans--Limited's managing director and that Ininco's office in Holland was merely a sales office. Indeed Whitehead testified as follows (R. 66-68):

Q Well, who ran Ininco for you?

A Mr. Evans for all intents and purposes.

and a Mr. Goldwater. When Franklin was asked about the appointment of Goldwater he testified that (R. 133-135) (1) that Goldwater was not an employee or director of Romney or Unex (2) that the only Board of Directors meeting he recalled Mr. Goldwater attending was one where Evans gave Franklin and Goldwater a progress report and (3) that he never discussed with Goldwater how they should vote on any particular matter. If Romney had been truly interested in influencing Ininco's affairs, surely Franklin, would have discussed with Goldwater how they should vote on any particular matter and how he should vote in order to protect Romney's interests.

9/ (continued)

Q Mr. Evans. That would mean that he was the Managing Director of Ininco?

A In practice, certainly.

* * *

Q Now, Ininco, as I understand it, Mr. Whitehead, did not have its own separate corporate headquarters, is that correct, in England?

A Separate headquarters? I don't believe so?

* * *

Q But in England, insofar as its operations in England, they were conducted out of Technicon Instruments Limited office; is that not correct?

A I believe so.

Most importantly, however, the events leading up to the liquidation of Ininco reveal that Romney failed to exercise its purported voting rights. It is undisputed, that taxpayers and their solicitor, Carr, without consulting Franklin, Goldwater or Romney, decided to terminate Ininco's activity by arranging a purported sale of Ininco to Hong Kong Holdings. Only after the terms of the purported "sale" were agreed upon was Romney advised of this liquidation of Ininco. While Romney held 50 percent of the nominal voting rights and theoretically could block this action it failed to do so notwithstanding that Franklin was indignant when told of the planned sale. (R. 112.) Indeed, even though Franklin was opposed initially to this sale, Romney, for cooperating in the sale, accepted only 900 pounds as a premium from a corporation whose net worth had increased from 45,000 pounds to 800,000 pounds. (R. 113, 114, 267.) In light of these facts and taxpayer's failure to show that Romney ever exercised a voice in management, it can hardly be said that Romney ever exercised its voting rights independently.

Rather the situation here like that in Garlock was such that Romney would have had little interest in disturbing taxpayers' control of Ininco. Ininco's sole business was selling Auto-anaylzers which Limited had manufactured. As the Tax Court found (R. 267) Ininco was established so that Technicon and Limited could expand their world-wide business while using

Ininco's tax-exempt earnings to finance the expansion of overseas sales offices. Neither Ininco, nor Romney, by virtue of its position as a purported Ininco shareholder, had an agreement with Limited or Technicon which assured it of a future source of supply of Autoanalyzers. Accordingly Ininco's existence and profit making ability depended entirely upon the cooperation of taxpayers. Romney's cooperation was, thus, assured.

Whitehead, nevertheless, argues (Br. 33-35) that Romney, even if Ininco's supplies of Autoanalyzers was cut off, could have refused to sell its shares in Ininco thus forcing Ininco to be kept alive. Yet this contention fails to take into account that if such a situation did arise, Intapco, as a practical matter, could have forced dissolution of Ininco simply by offering its shares for sale. The shareholders agreement of November 29, 1963, provided in effect that if Intapco desired to dispose of its shares in Ininco, the shares had to first be offered to Romney and vice versa. (R. 243.) If the shares offered were not purchased by the other shareholder, the offering shareholder could then either sell the shares to others or call for Ininco's liquidation. Since Ininco had accumulated a large amount of income and since Romney had a limited amount of capital (Ex. 13-M), Romney would not have been able to purchase Intapco's Ininco shares and Intapco could have forced

liquidation of Ininco.[10] Finally, even if Romney could have bought the Intapco shares, it would only purchase a shell corporation which would have no product to sell. Accordingly Romney would have little interest or opportunity to exercise a voice in management.

Clearly a principal purpose for giving Romney a nominal 50 percent voting right in Ininco was to avoid having Ininco classified as a controlled foreign corporation. Indeed Ininco was an important cog in a complicated piece of tax saving machinery. First, as a result of its being formed as an OTC, Ininco was exempt from United Kingdom tax on sales which it made outside that country.[11] Secondly, Ininco, by taking over Technicon's world-wide markets shifted potential Technicon income to Ininco. This resulted in a reduction of United States taxes. Thirdly, Ininco's existence was terminated

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10/ Whitehead also asserts (Br. 39) that such a liquidation would result in Intapco being forced to undergo financial sacrifice because of the 40 percent United Kingdom tax placed on the proceeds of liquidation. We note only that in actuality taxpayers here managed to liquidate Ininco without the resulting 40 percent tax.

11/ Ininco was so successful in this respect that the United Kingdom tax authorities did not allow Limited, as a manufacturing concern to shift all of its profits to the OTC. Thus, from its inception until its liquidation, 142,000 pounds of Ininco income was allocated to Limited by United Kingdom tax authorities. (R. 47, 156 ; Tr. 128; Exs. 26-Z, 32-FF and 36-JJ.)

through a series of complex procedures designed to avoid United Kingdom tax and its business was subsequently shifted to an Irish corporation after Ireland had granted it a tax exemption. While Ininco may also have been structured to qualify as a British OTC (Br. 42), Sections 957 and 1248 of the Code were also a primary consideration in structuring Ininco. Indeed taxpayers discussed the formation of Ininco with eminent United States tax counsel (R. 84). Thus, the taxpayer could not have gone to great lengths to avoid foreign taxes while overlooking United States tax consequences.

Finally, Whitehead (Br. 47-48) and Weiskopf (Br. 9-10) argue that this case is indistinguishable from that of CCA, Inc. v. Commissioner, 64 T.C. 137 (1975), where the Tax Court held that a corporation, formerly a wholly owned subsidiary of a United States corporation, was not a controlled foreign corporation. Yet in CCA the non United States shareholders not only held more than 50 percent of the voting rights but, unlike here, possessed significant powers under Swiss law which the Tax Court felt might be used to protect the interests of the non-United States shareholders. While the Tax Court here found (R. 262) that Romney had little interest in disturbing taxpayers' control over Ininco, in CCA the Tax Court (64 T.C., p. 151) said that it was "not prepared to state that the preferred shareholders possessing such wide powers were not disposed to

use such powers to protect the interest they did have." The Tax Court also found, that unlike Romney's representatives, the representatives of the preferred shareholders in CCA took an active part in considering various questions with respect to the conduct of the corporation's affairs. Thus, in CCA the Tax Court found that the former owners of the corporation did not retain dominion and control over the corporation.

Here as in Garlock and in Kraus the sum total of all the factors presented establishes that Ininco was a controlled foreign corporation.

II

THE TAX COURT CORRECTLY FOUND THAT THE ALLEGED "SALE" TO HONG KONG HOLDINGS OF THE INTAPCO STOCK AND THE ROMNEY SHARES IN ININCO WHICH WAS FOLLOWED BY THE LIQUIDATION OF ININCO WAS IN SUBSTANCE A LIQUIDATION OF ININCO BY THE TAXPAYERS

A. If Ininco was liquidated, taxpayer's share of the accumulated earnings would not be reduced by any of the distributions thereof

The special treatment accorded OTC's by the United Kingdom was abolished by legislation enacted in 1965 and effective on April 6, 1966. When taxpayers' solicitor Carr, advised taxpayers of this legislation and the fact that such legislation would result in Ininco no longer being exempt from United Kingdom income and profit tax on its current income, it was decided by taxpayers to terminate Ininco's existence. (R. 246.) Carr then discussed with Ininco's auditors and others the best method of doing this. It was determined that the liquidation of Ininco by Intapco and Romney would result in the imposition of a 40 percent British tax on the liquidation distributions but that United Kingdom law would permit a nonresident to receive dividends from Ininco in gross, without being subject to the tax. (R. 246.) Accordingly Carr suggested that, because of the favored tax provisions for nonresidents Intapco stock should be "sold" to a Hong Kong company--Hong Kong Holdings for the greater price of (1) 735,000 pounds or (2) the excess, less 15,000 pounds, of Ininco's assets over its liabilities. Taxpayers, as part of the agreement were to

procure the sale by Romney of its Ininco shares at par. The agreement was also contingent upon Hong Kong Holdings establishing to the satisfaction of the Commissioners of Inland Revenue certain conditions that would allow the tax free distribution of Ininco's accumulated earnings.

Hong Kong Holdings received the necessary approval for the contemplated transaction and the terms of the agreement were carried out. The minutes of the board of directors' meeting of March 14, 1966, and March 21, 1966, respectively reflect authorizations for the dividend payments of 500,000 pounds and 305,000 pounds and the minutes of the meeting of March 21, 1966, and March, 23, 1966, arranged for and authorized the liquidation of Ininco.

The Tax Court found (R. 271-272) that the taxpayers intended to find a corporation willing to acquire the stock of Intapco and the holdings of Romney in Ininco and then withdraw the earnings from Ininco and that the parties fully intended Hong Kong Holdings to liquidate Ininco. Thus, the Tax Court concluded that the overall transaction was, in substance, a liquidation so that the proceeds received by taxpayers in the transaction are ordinary income taxed as dividends, pursuant to Section 1248(a) of the Code.

Taxpayers, on the other hand, contend that the transfer of Intapco stock to Hong Kong Holdings was indeed a sale. If taxpayers prevail in this contention, Ininco would be treated as a controlled foreign corporation until the date of the transfer

of the Ininco stock. Its earnings and profits accumulated during the year would be reduced by the amount of dividend distributions it made, Treasury Regulations on Income Tax (1954 Code), Section 1.1248-3(b)(3), Appendix, infra, and taxpayers' interest in its earnings and profits accumulated during the taxable year in which the stock was sold would be prorated on a daily basis between the portions of the taxable year before and after the sale. Treasury Regulations on Income Tax (1954 Code), Section 1.1248-3(c)(1)(ii) Appendix, infra. Accordingly, taxpayers contend that dividends Ininco paid to Hong Kong Holdings operated to reduce Ininco's earnings and profits and that only those earnings and profits as so reduced can be taxed to them under Section 1248. Thus, they contend that a portion of the proceeds which they received is taxable at capital gains rates rather than ordinary income rates. Rev. Rul. 71-388, 1971-2 Cum. Bull. 314.[12/]

B. The transaction was a liquidation of Ininco by taxpayers

Though the form of the transaction here was a sale, the Tax Court correctly found that its substance was a liquidation of Ininco. The tax consequences of a transaction are determined not by the form in which the transaction is cast but by the reality of what has actually occurred. Knetsch v. United States, 364 U.S. 361, 365-366 (1960); Commissioner v. Court Holding Co., 324 U.S. 331, 334 (1945). As the Supreme Court has stated (Gregory v. Helvering, 293 U.S. 465, 469 (1935)):

12/ Even if the transaction were to be deemed a sale, the tax result would not be what taxpayers seek. Earnings and profits, under the above-cited provisions, are reduced only by dividend distributions. Here the Tax Court found (R. 272) that the parties

> The legal right of a taxpayer to decrease the amount of what otherwise would be his taxes, or altogether avoid them, by means which the law permits, cannot be doubted. * * * But the question for determination is whether what was done, apart from the tax motive, was the thing which the statute intended.

Similarly, this Court has stated that (Gilbert v. Commissioner, 248 F. 2d 399, 402 (C.A. 2, 1957))--

> the mere empty form of the transaction does not preclude further inquiry. It is always open to the Commissioner to prove that the transaction is not what it appears * * *

Thus, regardless of the absence of a tax-avoidance scheme or motive on a taxpayer's part, transactions must still be scrutinized to determine whether they have substance in economic terms. Ambassador Apartments, Inc. v. Commissioner, 406 F. 2d 288, 288-290 (C.A. 2, 1969). Accordingly, the Tax Court has the "power--indeed the duty--to look to the substance" of a taxpayer's transaction in determining its character for federal tax purposes. Comtel Corp. v. Commissioner, 376 F. 2d 791, 796 (C.A. 2, 1967); Blueberry Land Co. v. Commissioner, 361 F. 2d 93, 100-101 (C.A. 5, 1966).

With regard to such a determination, it has long been held that the question of whether a corporation has been liquidated is one of fact and is to be resolved by an objective determination of whether the corporation has manifested an intent "to wind up its affairs, gather in its resources, settle up its liabilities,

12/ (continued)
fully intended Hong Kong Holdings to liquidate Ininco. Thus the distributions Ininco made to Hong Kong Holdings were liquidating distributions, rather than dividend distributions. Such liquidating distributions should not reduce Ininco's earnings and profits for Section 1248 purposes.

cease taking on new business, and then distribute to its stockholders all that is left over." Genecov v. United States, 412 F. 2d 556, 561 (C.A. 5, 1969); O'Neill v. Commissioner, 271 F. 2d 44 (C.A. 9, 1959); Shore v. Commissioner, 286 F. 2d 742, 745 (C.A. 5, 1961); Kind v. Commissioner, 54 T.C. 600, 605 (1970). See Treasury Regulations on Income Tax (1954 Code), Section 1.332-2(c) (26 C.F.R.). It is not necessary that there be a formal plan of liquidation, Genecov, supra; Shore, supra; Kind, supra or that the corporation is considered to have been dissolved under local law. O'Neill, supra, p. 49; Kind, supra, p. 605. Rather a fundamental or "pragmatic" analysis is required, and the focus is on whether the corporation has ceased to be a going concern and has accordingly distributed its assets to its shareholders. Bittker & Eustice, Federal Income Taxation of Corporations and Shareholders (3d ed.), pp. 11-4-11-5.

Such finding of fact, of course, will not be reversed unless clearly erroneous. Commissioner v. Duberstein, 363 U.S. 278 (1960). Here it is clear that the transaction in question was not a sale for federal tax purposes because, in substance, all that taxpayers did was cause cash from one pocket (the corporation) to be transferred to another (the taxpayers) using a different pair of trousers (Hong Kong Holdings). See Owens v. Commissioner, 64 T.C. 1 (1975).13/

13/ Owens involved a taxpayer's attempt to avoid tax under Subchapter S of the Internal Revenue Code. In that case, the taxpayer owned all of the stock of a so-called "small business corporation" (commonly referred to as a Subchapter S corporation), and, consequently, was taxable, under Section 1373 of the Code (26 U.S.C.), on the corporation's undistributed taxable income. In 1965, the corporation had substantial taxable income that

As the Tax Court here found (Op. 40) the sole reason for the arrangement between Intapco and Hong Kong Holdings was the liquidation of Ininco in a manner that would permit taxpayers to minimize taxes paid to the United Kingdom. Indeed the Tax Court stated (Op. 40) "It is thus clear that the intent was to find a corporation willing to acquire the stock of Intapco and the holdings of Romney * * * and then withdraw [for a fee] the earnings from the corporation." The two steps were merely "component parts of a single transaction" that resulted in the liquidation of the corporation. See Jacobs v. Commissioner, 224 F. 2d 412, 414 (C.A. 9, 1955).

The evidence here fully supports such a finding. It is undisputed that while negotiations with Hong Kong Holdings were taking place, taxpayers obtained a tax exemption from the Republic of Ireland. Since that exemption applied to the profits of sales of products that were manufactured in Ireland and sold elsewhere,

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13/ (continued)
would have been includable in taxpayer's income at ordinary income tax rates. However, in an attempt to convert this ordinary income into capital gain, the taxpayer purported to sell his stock in the corporation to two outsiders. As was the situation in the present case, at the time of the so-called "sale," all of the assets of the corporation consisted of cash, and the purchasers simply used this cash to finance their purported "purchase" of the taxpayer's stock, extracting a fee for themselves in the process. The Tax Court held that such a transaction did not amount to a bona fide sale for federal income tax purposes, and that the taxpayer remained the corporation's sole shareholder irrespective of the transaction. Owens, therefore, is directly on point, and clearly supports the Tax Court's conclusion here that the transaction in issue was not a valid sale as far as tax purposes were concerned.

Limited reduced its output while a new Irish corporation, Technicon (Ireland) Ltd. began to manufacture and sell Autoanalyzers. (R. 41, 61, 64.) Hong Kong Holdings, of course, never sold any Autoanalyzers. (R. 96.)

Thus Hong Kong bought cash and accounts receivable encased in a corporate shell. Its only function, which it performed for a fee, was to distribute that cash, free from British taxation, to the taxpayers. Yet the Tax Court has recognized "When one purports to sell cash in a corporate solution the burden is surely particularly severe on the seller to show that the only purpose served is not tax avoidance." Gray v. Commissioner, 56 T.C. 1032, 1069 (1971), appeal pending (C.A. 9, Nos. 75-1041-75-1046). 14/

This is also the clear thrust of the Fourth Circuit's holding in Lowndes v. United States, 384 F. 2d 635 (C.A. 4, 1967) aff'd, 258 F. Supp. 193 (Md., 1966). There the court considered the tax effects upon a "purchaser" in a cash for cash transaction.

14/ Gray involved a situation in which the taxpayers decided to "terminate" their interest in Yarg, the family's wholly-owned Canadian corporation. The decision occasioned considerable tax planning on the part of taxpayers and their advisers aimed at avoiding as many incidents of both United States and Canadian tax as possible. Two Canadian companies, Cameron and Dabne, agreed to purchase the stock of Yarg for the net book value of its assets less 4 1/2 percent, provided all of its assets were converted to cash. The Tax Court held that the substance of the purported sale to Cameron and Dabne constituted a liquidation for tax purposes.

In <u>Lowndes</u> the taxpayer purchased the stock of four fourth tier subsidiaries of the Bethlehem Steel Company. The subsidiaries, like Ininco, had previously closed all active operations and their assets consisted entirely of cash. Bethlehem, in order to avail itself of a cash deduction, purportedly sold its stock in these corporations to the taxpayer who then held the stock for six months before liquidating the corporations. The taxpayer claimed that the gain realized on the liquidation of the corporation was taxable at capital gains rates. The Fourth Circuit held, however, that in substance the transaction was nothing more than the immediate purchase of cash at a discount. Thus, the taxpayer's formal purchase of the stock and subsequent liquidation of the four corporations were disregarded (384 F. 2d, pp. 638-639):

> * * * The taxpayer was willing to assist Bethlehem in effecting an arrangement advantageous to it in return for a fee, though not so denominated. Under such circumstances, a "bargain purchase" is taxable as immediate income.
>
> * * *
>
> * * * <u>We have here no purchase for investment purposes of property which may appreciate in value</u>. There is no suggestion of negotiations concerning the value of property consisting solely of a liquid bank account. If there was any bargaining at all, it was over the amount of the differential between the purchase price and the corporate bank account.
>
> * * *

> The compensation for services rendered was immediately reportable as ordinary gain. The subsequent liquidation of the corporations, whether effected in the year of purchase, the next year, or any other time, is entirely immaterial in determining either the character of the gain or the date of its realization. (Emphasis supplied.) 15/

The Lowndes case clearly stands for the proposition that a purported "sale" or "purchase" of cash encased in a corporate shell is, in reality, no sale at all. As in Lowndes, Hong Hong Holdings did not acquire or purchase stock in a viable corporation with real assets and actual business prospects. It simply entered into an exchange of equivalent amounts of cash "in return for a fee." Lowndes v. United States, supra, p. 639.

Taxpayers, nevertheless, assert (Weiskopf, Br. 16) that there was no agreement on Hong Kong's part to liquidate Ininco. While as the Tax Court recognized (R. 272) from the purely technical standpoint this may be correct, it is clear that liquidation of Ininco was an integral part of the arrangement between Hong Kong and taxpayers. Indeed, the agreement provided that "in the event the Purchaser [Hong Kong Holdings] shall fail before the date on which the liquidation of Ininco commences to

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15/ Since the Court in Lowndes disregarded the taxpayer's subsequent liquidation of the four corporations as far as her tax liability was concerned, the only logical inference must be that the Court thought that, for tax purposes, the corporations had in effect been liquidated by Bethlehem under the guise of the so-called "sales" transactions. Thus, Weiskopf's reference to lack of judicial authority in this area (Br. 13) is incorrect.

satisfy the Commissioners * * *" then the purchaser shall be entitled to rescind the transaction. Thus, the Tax Court found that the provision indicated that the parties fully intended for Hong Kong Holdings to liquidate Ininco because the parties intended to use the tax free distribution of Ininco's earnings to pay taxpayers for their stock interest in Intapco. In Blueberry Land Co. v. Commissioner, 361 F. 2d 93 (C.A. 5, 1966) taxpayer raised a similar contention which was rejected. There the taxpayer corporation, whose sole assets were installment obligations, had all of its stock purchased by an intermediate corporation with a limited capitalization. This intermediate corporation then liquidated the corporation and sold the taxpayers assets to the ultimate purchaser retaining a small profit. In holding that for tax purposes the transaction was a sham in that the taxpayers in fact sold the installment obligations which were taxable at ordinary income rates rather than the stock which was taxable as capital gain, the Fifth Circuit stated 361 F. 2d, p. 99):

> What all of these parties, living and corporate, so well understood the trier hardly had to ignore.
>
> We have no doubt that the Tax Court was warranted in concluding that the Commissioner could properly disregard the intermediate step * * * and treat the disposition of the mortgages as a sale thereof by Taxpayers.

Thus, the Court concluded (361 F. 2d, p. 102):

> Nothing here said is intended to prevent or in any way discourage a real and bona fide sale of stock by stockholders of one corporation to a second corporation,

> and liquidation of the first by the acquiring corporation to obtain its assets.

Yet like the situation here, missing was (p. 102)--

> that all-important element--the transaction must be real and bona fide. That means at least that where tax consequences require that the acquiring corporation be independent, the plan fails if it is in fact the agent, or tool of the selling stockholders or their corporation.

Taxpayers also rely on Granite Trust Co. v. United States, 238 F. 2d 670 (C.A. 1, 1956) and Commissioner v. Day & Zimmerman, Inc., 151 F. 2d 517 (C.A. 3, 1945). Those cases involved situations where taxpayers transferred 20.5 percent of the stock of a wholly owned subsidiary to a friendly party in order to give the taxpayer less than 80 percent of "continued voting power" so as to permit it to recognize a loss or liquidation of the subsidiary under Section 112(b)(6) of the Internal Revenue Code of 1939 (26 U.S.C. 1952 ed.). Since the courts in those cases allowed the losses to be recognized, Weiskopf asserts (Br. 12) that a shareholder may dispose of his ownership in a corporation by sale or liquidation--the result for tax purposes turning on taxpayer's choice. But in Granite Trust and in Day and Zimmerman, the courts found that the transfer of the stock and, thus, the transactions were real. Accordingly, those cases are not applicable here since Hong Kong Holdings was a mere conduit in a transaction which had no substance and which would have been rescinded had not the Commissioner of Inland Revenue bestowed favorable tax consequences upon it. See Garlock, 389 F. 2d, p. 202, fn. 4.

Nor does the fact that the British Inland Revenue ruled favorably on the transaction aid taxpayers' case. For indeed, it is well settled that a case such as that here is not concerned with * * * the legal effectiveness of the transaction under the law of the United Kingdom, but with whether the transaction has substance for United States "federal tax purposes." United States v. General Geophysical Co., 296 F. 2d 86, 89 (C.A. 5, 1961); Commissioner v. Tower, 327 U.S. 280, 288 (1946); Estate of Starr v. Commissioner, 274 F. 2d 293, 294-295. This question is to be resolved in terms of the "pertinent Federal law"--in other words in light of the intendment of the federal tax status involved. Hudspeth v. United States, 471 F. 2d 275, 277 (C.A. 8, 1972); Kind v. Commissioner, 54 T.C. 600, 605 (1970); Frelmort Realty Corp. v. Commissioner, 29 B.T.A. 181, 187-190 (1933) cf. Commissioner v. Brown, 380 U.S. 563 (1956) where the Court took special care to address itself to the meaning of the term sale as it is used in the Internal Revenue Code.

Nor is it correct to say (Weiskopf, Br. 16-17) that taxpayers did not have the right to liquidate Ininco because Intapco could not liquidate Ininco without the cooperation of Romney. As we have shown, supra, p. 31, Intapco, as a result of Romney's limited capitalization and Ininco's large accumulation of earnings, could force dissolution of Ininco simply by offering its shares for sale.16/

16/ Taxpayers statement that (Weiskopf, Br. 17) "the separate corporate existence of Intapco must be respected" is erroneous.

Finally, we note that taxpayers err when they state (Weiskopf, Br. 14) that Gray, supra, and Owens, supra, are distinguishable because they involve a predetermined amount of profit for the purchasers there while Hong Kong Holdings here did not secure a predetermined profit. What taxpayers fail to recognize is that Hong Kong Holdings was guaranteed a profit of 15,000 pounds in the transaction because it was required to "pay" only the excess of Ininco's assets over its liabilities less 15,000 pounds and at that time Ininco's only assets were cash and accounts receivable. (R. 248.) 17/

16/ (continued)
It is undisputed that Intapco was a domestic corporation "formed or availed of prinicpally for the holding directly or indirectly of stock of one or more foreign corporations" (Sec. 1248(e); Treasury Regulations on Income Tax. § 1.1248-6, Appendix, infra) If the stock of a domestic corporation, which holds as its only asset the stock of a controlled foreign corporation, is "sold" to another corporation, the gain on the "sale" or liquidation of the parent corporation would produce dividend income under Section 1248(a). See Sec. 1248(e), Internal Revenue Code of 1954, and 240-2nd Tax Management, Controlled Foreign Corporations Section 1248, p. A-7.

17/ While the agreement provided alternatively that Hong Kong would pay 735,000 pounds if that amount was greater than the purchase price described above, we assume that the figure of 735,000 pounds was designed to guarantee Hong Kong Holdings a profit in the transaction. Indeed the agreement (Ex. 20-T) warranted that the excess of Ininco's assets over its liabilities would not be less than that amount.

Clearly this shows that the transaction in question was a mere shifting of cash, for a fee, to avoid certain tax consequences. As the Tax Court noted, Section 1248 was enacted to provide "the imposition of the full United States tax when income earned abroad is repatriated. S. Rep. No. 1881, 87th Cong., 2d Sess., pp. 1, 107 (1962-3 Cum. Bull. 707, 813). This aim can only be supported here by affirming the finding of the Tax Court that the purported sale was in substance a liquidation.

III

THE TAX COURT CORRECTLY DETERMINED THAT WEISKOPF SHOULD BE CONSIDERED AS HAVING OWNED ONE HALF THE COMMON STOCK OF INTAPCO FROM ITS INCEPTION SO THAT ONE HALF OF ININCO'S EARNINGS AND PROFITS ARE ATTRIBUTABLE TO HIM

Section 1248 of the Code provides that if a United States person receives a distribution from a controlled foreign corporation or sells or exchanges stock in such a corporation the gain recognized shall be taxed as a dividend to the extent of the corporation's earnings and profits attributable to such stock.

The Tax Court held that Weiskopf should be treated as having owned one half of the Intapco common stock from the corporation's inception so that one half of Ininco's accumulated earnings and profits are attributable to him for purposes of Section 1248. Weiskopf contends, however (Br. 18) that during

the years 1964, 1965 and the relevant part of 1966 (with the exception of one day) his interest in Intapco and consequently Ininco was limited to a fixed dividend on preferred stock so that the Tax Court attributed excess earnings and profits to his Intapco stock. Yet this contention fails to take into account the fact that Weiskopf's true interest in Intapco was considerably greater than a mere interest in Intapco's preferred stock. When Intapco was incorporated, Weiskopf and Intapco entered into an agreement which granted Weiskopf the option of converting his preferred Intapco stock into Intapco common stock (1) if Intapco were to terminate its interest in a company affiliated with Technicon (2) if Intapco or its subsidiary failed to do business with Technicon for four months; (3) if Intapco authorized any distribution in respect of its common stock, or (4) if the holders of the common stock agreed to its sale or disposition. Thus, Weiskopf had the right, and indeed exercised that right, to convert his preferred stock into one half of the Intapco common stock at any time a situation would arise which would cause Ininco's earnings and profits to be distributed. Accordingly, Weiskopf's true interest in Intapco--ownership of the common stock--should be recognized for purposes of Section 1248.

Moreover, Weiskopf misconceives the effect of the inter-relationship of Section 1248 and Section 1223 of the Internal Revenue Code of 1954, Appendix, <u>infra</u>. Section 1223 provides that the holding period of property acquired in a tax-free

exchange (such as the Intapco common stock here) is considered to have tacked on to it the holding period of the property given up in the exchange. The Section also provides that the basis of property acquired in a tax-free exchange is the basis of the property which has been given up. Thus, Weiskopf was considered, under Section 1223, to have held his share of the Intapco common stock from the time he purchased the preferred Intapco stock in 1963 and it was stipulated that Weiskopf's basis in the Intapco common stock was $49,000--the amount he paid for the preferred stock. The Treasury Regulations on Income Tax, § 1.1248-1(a)(1), Appendix, <u>infra</u>, provide that if a United States person recognizes gain on the sale or exchange of stock in a foreign corporation that gain shall be includable to the extent of earnings and profits of the corporation "during the period or periods such stock was held (or was considered as held by reason of the applicatio of section 1223) by such person while such corporation was a controlled foreign corporation." Accordingly Weiskopf, who is considered to have held Intapco common from the time he purchased the Intapco preferred stock in 1963, should have his gain taxed as ordinary income to the extent of Ininco's accumulated earnings and profits from 1963.

There is no support for Weiskopf's contention (Br. 19) that the earnings and profits attributable to the preferred stock are tacked to common stock received by Weiskopf in 1966.

Indeed, this contention is completely contrary to his statement (Br. 19) that "Section 1223 applies, for example, to transfers of stock from one taxpayer to another by gift or in a tax-free exchange, and causes the earnings and profits attributable to the stock to adhere to the stock in the hands of its new owner."

Weiskopf's hypotheticals (Br. 20) have no relevance to the facts of this case and do not support his position.[18/] While he seeks to use them to suggest that there should be a one-to-one relationship between amounts taxed at ordinary income rates and the repatriated earnings and profits of a controlled foreign corporation, this is not the law. Congress intended that, in certain situations, Section 1248 treatment shall apply to more than a controlled foreign corporation's earnings and profits. Such discontinuities are within the Congressional intendment.[19/]

18/ It is highly questionable whether these hypotheticals reflect economic reality. Hypothetical (1) (Weiskopf, Br. 20), for example, envisages the sale to a third party of all the corporation's common stock at a price reflecting the corporation's entire earnings and profits notwithstanding the fact that B (p. 20), the preferred shareholder, has the right to convert his preferred stock into common stock, severely restricting the third party's equity in the corporation.

19/ Such discontinuities are prevelant throughout the Code. See Nesson, Earnings And Profits Discontinuities Under The 1954 Code, 77 Harv. Rev. 450 (1964).

Section 1248(g) of the Code, for example, specifically provides that unless a taxpayer specifically establishes the amount of earnings and profits of a controlled foreign corporation to be taken into account under Section 1248, all the gain from the sale or exchange of its stock shall be treated as dividend income. The Tax Court has noted, that the rationale of the stringent provisions of Section 1248 and corresponding sections of the Code lies (1) in the desire of Congress to tax fully repatriated foreign source income, (2) the consideration of past and continued tax deferral and (3) the corresponding possibility of earnings and profits escaping United States taxation forever. H. H. Robertson Co. v. Commissioner, 59 T.C. 53, 73, fn. 9 (1972), aff'd per curiam (C.A. 3, July 24, 1974), a case where the taxpayer was taxed twice on a foreign subsidiary's accumulated earnings.

Here of course, were Weiskopf to prevail with his contentions, the inequities would fall upon the Government. The earnings and profits of Ininco which had not been subject to United States taxation would completely escape being taxed at ordinary income rates by virtue of the artifice of Weiskopf having owned only Ininco preferred stock. Such a result is not permitted.

CONCLUSION

The decisions of the Tax Court should be affirmed.

Respectfully submitted,

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CERTIFICATE OF SERVICE

It is hereby certified that service of this brief has been made on opposing counsel by mailing two copies thereof to each on this 26th day of March, 1976, in envelopes, with postage prepaid, properly addressed to each of them, respectively, as follows:

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APPENDIX

Internal Revenue Code of 1954 (26 U.S.C.):

SEC. 951 [as added by Sec. 12(a), Revenue Act of 1962, P.L. 87-834, 76 Stat. 960]. AMOUNTS INCLUDED IN GROSS INCOME OF UNITED STATES SHAREHOLDERS.

*   *   *

(b) United States Shareholder Defined.--For purposes of this subpart, the term "United States shareholder" means, with respect to any foreign corporation, a United States person (as defined in section 957(d)) who owns (within the meaning of section 958(a)), or is considered as owning by applying the rules of ownership of section 958(b), 10 percent or more of the total combined voting power of all classes of stock entitled to vote of such foreign corporation.

*   *   *

SEC. 957 [as added by Sec. 12(a), Revenue Act of 1962, supra]. CONTROLLED FOREIGN CORPORATIONS; UNITED STATES PERSONS.

(a) General Rule.--For purposes of this subpart, the term "controlled foreign corporation" means any foreign corporation which more than 50 percent of the total combined voting power of all classes of stock entitled to vote is owned (within the meaning of section 958(a)), or is considered as owned by applying the rules of ownership of section 958(b), by United States shareholders on any day during the taxable year of such foreign corporation.

(b) Special Rule for Insurance.--For purposes only of taking into account income described in section 953(a) (relating to income derived from insurance of United States risks), the term "controlled foreign corporation" includes not only a foreign corporation as defined by subsection (a) but also one of which more than 25 percent of the total combined voting power of all classes of stock is owned (within the meaning of section 958(a)), or is considered as owned by applying the rules of ownership of section 958(b), by United States shareholders on any day during the taxable year of such corporation, if the gross amount of premiums or other consideration in respect of the reinsurance or the issuing of insurance or annuity contracts described in section 953(a)(1) exceeds 75 percent of the gross amount of all premiums or other consideration in respect of all risks.

* * *

(d) United States Person.--For purposes of this subpart, the term "United States person" has the meaning assigned to it by section 7701(a)(30) * * *

* * *

SEC. 1223. HOLDING PERIOD OF PROPERTY.

For purposes of this subtitle--

(1) In determining the period for which the taxpayer has held property received in an exchange, there shall be included the period for which he held the property exchanged if, under this chapter, the property has, for the purpose of determining gain or loss from a sale or exchange, the same basis in whole or in part of his hands as the property exchanged, and, in the case of such exchanges after March 1, 1954, the property exchanged at the time of such exchange was a capital asset as defined in section 1221 or property described in section 1231. For purposes of this paragraph--

* * *

SEC. 1248 [as added by Sec. 15(a), Revenue Act of 1962, supra]. GAIN FROM CERTAIN SALES OR EXCHANGES OF STOCK IN CERTAIN FOREIGN CORPORATIONS.

(a) General Rule.--If--

(1) a United States person sells or exchanges stock in a foreign corporation, or if a United States person receives a distribution from a foreign corporation which, under section 302 or 331, is treated as an exchange of stock, and

(2) such person owns, within the meaning of section 958(a), or is considered as owning by applying the rules of ownership of section 958(b), 10 percent or more of the total combined voting power of all classes of stock entitled to vote of such foreign corporation at any time during the 5-year period ending on the date of the sale or exchange when such foreign corporation was a controlled foreign corporation (as defined in section 957),

then the gain recognized on the sale or exchange of such stock shall be included in the gross income of such person as a dividend, to the extent of the earnings and profits of the foreign corporation attributable (under regulations prescribed by the Secretary or his delegate) to such stock which were accumulated in taxable years of such foreign corporation beginning after December 31, 1962, and during the period or periods the stock sold or exchanged was held by such person while such foreign corporation was a controlled foreign corporation.

* * *

(e) [as added by Sec. 15(a), Revenue Act of 1962, supra]. Sales or Exchanges of Stock in Certain Domestic Corporations.--Under regulations prescribed by the Secretary or his delegate, if--

(1) A United States person sells or exchanges stock of a domestic corporation, or receives a distribution for a domestic corporation which, under section 302 or 331, is treated as an exchange of stock, and

(2) such domestic corporation was formed or availed of principally for the holding, directly or indirectly, of stock of one or more foreign corporations,

such sale or exchange shall, for purposes of this section, be treated as a sale or exchange of the stock of the foreign corporation or corporations held by the domestic corporation.

* * *

SEC. 7701. DEFINITIONS.

(a) When used in this title, where not otherwise distinctly expressed or manifestly incompatible with the intent thereof--

* * *

(30) [as added by Sec. 7(h), Revenue Act of 1962, supra]. United States person.--The term "United States person" means--

(A) a citizen or resident of the United States,

(B) a domestic partnership,

(C) a domestic corporation, and

(D) any estate or trust (other than a foreign estate or foreign trust, within the meaning of section 7701(a)(31)).

* * *

Treasury Regulations on Income Tax (1954 Code) (26 C.F.R.):

§ 1.957-1 Definition of controlled foreign corporation.

* * *

(b) Percentage of total combined voting power owned by United States shareholders--(1) Meaning of combined voting power. In determining for purposes of paragraph (a) of this section whether United States shareholders own the requisite percentage or total combined voting power of all classes of stock entitled to vote, consideration will be given to all the facts and circumstances of each case. In all cases, however, United States shareholders of a foreign corporation will be deemed to own the requisite percentage of total combined voting power with respect to such corporation--

(i) If they have the power to elect, appoint, or replace a majority of that body of persons exercising, with respect to such corporation, the powers ordinarily exercised by the board of directors of a domestic corporation;

(ii) If any person or persons elected or designated by such shareholders have the power, where such shareholders have the power to elect exactly one-half of the members of such governing body of such foreign corporatin, either to cast a vote deciding an evenly divided vote of such body or, for the duration of any deadlock which may arise, to exercise the powers ordinarily exercised by such governing body; or

(iii) If the powers which would ordinarily be exercised by the board of directors of a domestic corporation are exercised with respect to such foreign corporation by a person whom such shareholders have the power to elect, appoint, or replace.

(2) Shifting of formal voting power. Any arrangement to shift formal voting power away from United States shareholders of a foreign corporation will not be given effect if in reality voting power is retained. The mere ownership of stock entitled to vote does not by itself mean that the shareholder owning such stock has the voting power of such stock for purposes of section 957. For example, if there is any agreement, whether express or implied, that any shareholder will not vote his stock or will vote it only in a specified manner, or that shareholders owning stock having not more than 50 percent of the total combined voting power will exercise voting power normally possessed by a majority of stockholders, then the nominal owership of the voting power will be disregarded in determining which shareholders actually hold such voting power, and this determination will be made on the basis of such agreement. Moreover, where United States shareholders own shares of one or more classes of stock of a foreign corporation which has another class of stock outstanding, the voting power ostensibly provided such other class of stock will be deemed owned by any person or persons on whose behalf it is exercised or, if not exercised, will be disregarded if the percentage of voting power of such other class of stock is substantially greater than its proportionate share of the corporate earnings, if the facts indicate that the shareholders of such other class of stock do not exercise their voting rights independently or fail to exercise such voting rights, and if a principal purpose of the arrangement is to avoid the classification of such foreign corporation as a controlled foreign corporation under section 957.

* * *

§ 1.1248-1 Treatment of gain from certain sales or exchanges of stock in certain foreign corporations.

(a) In general. (1) If a United States person (as defined in section 7701(a)(30)) recognizes gain on a sale or exchange after December 31, 1962, of stock in a foreign

corporation, and if in respect of such person the conditions of subparagraph (2) of this paragraph are satisfied, then the gain shall be included in the gross income of such person as a dividend to the extent of the earnings and profits of such corporation attributable to such stock under § 1.1248-2 or 1.1248-3, whichever is applicable, which were accumulated in taxable years of such foreign corporation beginning after December 31, 1962, during the period or periods such stock was held (or was considered as held by reason of the application of section 1223) by such person while such corporation was a controlled foreign corporation. See section 1248(a). For computation of earnings and profits attributable to such stock if there are any "lower tier" corporations, see paragraph (a) (3) and (4) of § 1.1248-2 or paragraph (a) of § 1.1248-3, whichever is applicable. In general, the amount of gain to be included in a person's gross income as a dividend under section 1248 (a) shall be determined separately for each share of stock sold or exchanged. However, such determination may be made in respect of a block of stock if earnings and profits attributable to the block are computed under § 1.1248-2 or 1.1248-3. See paragraph (b) of § 1.1248-2 and paragraph (a)(5) of § 1.1248-3. For the limitation on the tax attributable to an amount included in an individual's gross income as a dividend under section 1248(a), see section 1248 (b) and § 1.1248-4. For the treatment, under certain circumstances, of the sale or exchange of stock in a domestic corporation as the sale or exchange of stock held by the domestic corporation in a foreign corporation, see section 1248(e) and § 1248-6. For the nonapplication of section 1248 in certain circumstances, see section 1248(f) and paragraph (e) of this section. For the requirement that the person establish the amount of earnings and profits attributable to the stock sold or exchanged and, for purposes of section 1248(b), the amount of certain taxes, see section 1248(g) and § 1.1248-7.

* * *

§ 1.1248-3 <u>Earnings and profits attributable to stock in complex cases</u>.

* * *

(b) <u>Earnings and profits accumulated for a taxable year</u>--***

* * *

(3) <u>Adjustment for distributions</u>. (i) The earnings and profits of a foreign corporation accumulated for a

taxable year (computed without regard to this subparagraph) shall be reduced (if necessary below zero so as to create a deficit), or a deficit in such earnings and profits shall be increeased, by the amount of the distributions (other than in redemption of stock under section 302(a) or 303) made by the corporation in respect of its stock during such taxable year (a) our to such earnings and profits, or (b) out of earnings and profits accumulated for prior taxable years beginning after December 31, 1962 (computed under this paragraph). Except for purposes of applying this subparagraph, the application of the preceding sentence shall not affect the amount of earnings and profits accumulated for any such prior taxable year.

*   *   *

(c) Tentative ratable share if earnings and profits accumulated for a taxable year not less than zero--(1) General rule. For purposes of paragraph (a)(2)(ii) of this section, in respect of a share (or block) of stock in a foreign corporation, if the amount of the earnings and profits accumulated for a taxable year of the corporation (computed under paragraph (b) of this section), beginning after December 31, 1962, is not less than zero, then the person's tentative ratable share for such taxable year shall be equal to--

*   *   *

(ii) The percentage that (a) number of days in such taxable year of the corporation during the period the person held (or was considered to have held by reason of the application of section 1223) the share (or block) while the corporation was a controlled foreign corporation, bears to (b) the total number of days in such taxable year.

*   *   *

§ 1.1248-6 Sale or exchange of stock in certain domestic corporations.

(a) General rule. If a United States person recognizes gain upon the sale or exchange of a share (or block) of stock of a domestic corporation which was formed or availed of principally for the holding, directly or indirectly, of stock of one or more foreign corporations, and if the

conditions of paragraph (a) (2) of § 1.1248-1 would be met by such person in respect of the share (or block) if the domestic corporation were a foreign corporation, then section 1248 shall apply in respect of such gain in accordance with the rules provided in paragraph (b) of this section.

(b) Application. (1) The gain referred to in paragraph (a) of this section shall be included in the gross income of the United States person as a dividend under section 1248(a) to the extent of the earnings and profits attributable under § 1.1248-2 or § 1.1248-3, whichever is applicable, to the share (or block), computed, however, in accordance with the following rules:

(1) The domestic corporation shall be treated as if it were a first tier foreign corporation;

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